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10 **BOARD OF EQUALIZATION**

11 **STATE OF CALIFORNIA**

12 In the Matter of the Appeal of:

) **HEARING SUMMARY²**

) **PERSONAL INCOME TAX APPEAL**

13 **MORGAN GARNETT¹**

) Case No. 491096

	<u>Year</u>	<u>Proposed Tax Assessment</u>	<u>Penalty³</u>
	2002	\$51,458	\$1,983

14 Representing the Parties:

15 For Appellant: Mark A. Muntean, Attorney

16 For Franchise Tax Board: Ann H. Hodges, Tax Counsel IV

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23 ¹ In a supplemental brief dated March 10, 2010, appellant's representative describes appellant as a minor. A Power of Attorney, filed on appellant's behalf, lists an address for appellant in San Mateo County, California.

24 ² This appeal was originally set for oral hearing at the July 13-15, 2010 Board meeting. The matter was postponed to the
 25 November 16-18, 2010 Board meeting as appellant's representative had a scheduling conflict. The matter was then
 26 postponed to the February 22-24, 2011 Board meeting, as appellant's father had a scheduling conflict. The matter was then
 27 deferred to the May 24-26, 2011 Board meeting at appellant's request.

28 ³ This is the post-amnesty penalty amount assessed pursuant to R&TC section 19777.5, subd. (a)(2). California imposes a
 post-amnesty penalty under R&TC section 19777.5 for any underpayment of an eligible tax year beginning before January 1,
 2003, that became final after the end of the amnesty period (i.e., March 31, 2005). The Board's jurisdiction to review an
 amnesty penalty is limited to situations where the penalty is assessed and paid, the taxpayer files a timely appeal from the
 denial of a refund claim, and the taxpayer alleges a computational error in the penalty.

1 QUESTIONS: (1) Whether the stock held by appellant met the “active business requirements” of
2 Revenue and Taxation Code (R&TC) section 18152.5, such that appellant
3 qualifies for the 50 percent exclusion from gain on the sale of “qualified small
4 business stock” (QSBS).
5 (2) Whether the Board has jurisdiction to consider the constitutionality of R&TC
6 section 18152.5 and, if so, if the statute violates the Commerce Clause of the
7 United States Constitution.

8 HEARING SUMMARY

9 Background

10 Appellant is a California resident who reported on her 2002 California return that stock
11 sold qualified as “qualified small business stock” under R&TC section 18152.5 and that 50 percent of
12 the gain from the sale of the stock was excludable from her gross income. Appellant purchased 500,000
13 shares of CrossWorlds Software, Inc. (hereafter “CrossWorlds” or “corporation”) on March 11, 1996,
14 and another 500,000 shares of CrossWorlds’s stock on November 15, 1996. On October 1, 1999, the
15 corporation’s board of directors authorized a 1:3 reverse split, leaving appellant with 333,332 shares. At
16 the time of the stock sale in 2002, as detailed below, appellant reported a gain of \$1,302,660, and
17 excluded 50 percent, or \$651,330, of the gain.

18 CrossWorlds was incorporated in March 1996 as a domestic C corporation. Appellant’s
19 mother, Katrina Garnett, was the founder and chief executive officer of the corporation and her father,
20 Terrence Garnett, was a director of the corporation. CrossWorlds’s initial public offering was on June 1,
21 2000, and the corporation was acquired by IBM on January 11, 2002. (Resp. Opening Br., p. 4; Resp.
22 Reply Br., p. 1.) According to the December 31, 2000 Form 10-K filed by CrossWorlds with the
23 Securities and Exchange Commission (SEC), the corporation had a total of 328 employees as of
24 December 31, 2000, of which 272 were based in North America and 56 were based in Europe
25 (principally in the United Kingdom, Germany, and France). In the United States, CrossWorlds had
26 offices in California, Colorado, Connecticut, Georgia, Illinois, Maryland, Michigan, Minnesota, New
27 Jersey, North Carolina, and Washington. (Resp. Opening Br., Exhibit E, pp. 4-5.)

28 The stock was sold on January 15, 2002, and was held in a trust at the time of its sale.

1 Appellant was an 84.07 percent beneficiary of the trust and she was allocated \$1,303,080 of the
2 proceeds from the stock sale. With appellant's \$420 basis in the stock, appellant reported a gain of
3 \$1,302,660 (i.e., \$1,303,080 proceeds - \$420 basis) and that she was entitled to exclude 50 percent of the
4 gain, an exclusion of \$651,330 (i.e., \$1,302,660 x 50 percent), pursuant to R&TC section 18152.5.⁴

5 On audit, respondent denied appellant's exclusion of 50 percent of the gain from the sale
6 of the CrossWorlds's stock, concluding that, although appellant met several of the requirements under
7 RT&C section 18152.5, the corporation failed to meet the "active business requirements" of subdivision
8 (e) of the statute. Respondent stated in the Explanation of Audit Adjustments (Resp. Opening Br.,
9 Exhibit G, p. 5) that under subdivision (c)(2)(A) of the statute, a corporation must meet the active
10 business requirements of R&TC section 18152.5, subd. (e), for "substantially all" of a taxpayer's
11 holding period. Respondent further stated that, under subdivisions (e)(1) and (e)(9) of R&TC section
12 18152.5, a corporation must have at least 80 percent of its assets and payroll expenses attributable to
13 California during a taxpayer's holding period of the corporation's stock. Respondent found that
14 CrossWorlds met the 80 percent asset test throughout appellant's holding period, but failed the 80
15 percent payroll test. Respondent observed that the term "substantially all" has been interpreted to be no
16 less than 70 percent and also at least 85 percent. Regarding appellant, respondent found that the
17 corporation only met the active business requirements R&TC section 18152.5, subd. (e), during 31
18 percent of appellant's holding period, such that the stock did not qualify for qualified small business
19 stock treatment. (Resp. Opening Br., Exhibit G, pp. 4-6.)

20 Based upon these audit results, respondent issued a Notice of Proposed Assessment
21 (NPA) dated March 30, 2007. The NPA was protested and respondent subsequently issued a Notice of
22 Action on May 4, 2009, affirming the NPA. This timely appeal followed.

23 Overview

24 R&TC section 18152.5, subdivision (a), provides that, if certain conditions are met, a
25 taxpayer may exclude 50 percent of the gain from the sale of qualified small business stock. As
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27 ⁴ Both appellant and respondent have stated that appellant purchased the CrossWorlds's stock, but that the stock was held in a
28 trust at the time of its sale. Neither appellant nor respondent have explained how the trust became the holder of the stock.
Nevertheless, the parties do not dispute that appellant was a beneficiary of this trust and that the income from the sale of the
CrossWorlds's stock should be attributed to appellant.

1 explained further below, there are many requirements that must be met under R&TC section 18152.5 for
2 stock to be considered “qualified small business stock.” Among these requirements, subdivision
3 (c)(2)(A) of R&TC section 18152.5 provides that “[s]tock in a corporation shall not be treated as
4 qualified small business stock unless, during *substantially all* of the taxpayer’s *holding period* for the
5 stock, the corporation meets the *active business requirements* of subdivision (e) . . .” (Italics added.)
6 Subdivision (e) of R&TC section 18152.5 provides that a corporation must meet an 80 percent asset test
7 and an 80 percent payroll test. (The 80 percent asset test is not at issue in this appeal.) Subdivision
8 (e)(9) of the statute provides that no more than 20 percent of a corporation’s total payroll expense can be
9 attributable to employment located outside of California. Or, conversely, 80 percent or more of a
10 corporation’s *total payroll expense* must be attributable to employment in California.

11 Appellant has raised three sub-issues relating to R&TC section 18152.5, subd. (c)(2)(A),
12 which are addressed below: (1) the inclusion of stock options paid by CrossWorlds as part of the
13 corporation’s “total payroll expense”; (2) the definition of the term “substantially all” as part of the
14 clause “substantially all of the taxpayer’s holding period of the stock”; and (3) the definition of the term
15 “holding period” as part of the clause “the taxpayer’s holding period of the stock.”

16 Contentions

17 Appellant’s Contentions

18 Appellant contends that the corporation meets the active business requirements of R&TC
19 section 18152.5. Appellant also contends that respondent incorrectly adjusted appellant’s calculation of
20 the alternative minimum tax (AMT) amount, such that appellant is appealing that adjustment as well.
21 (App. Opening Br., p. 2.)

22 The 80-Percent Payroll Test

23 Appellant asserts that respondent inappropriately relied upon California Schedule 100R
24 for purposes of determining whether appellant met the 80 percent payroll test of R&TC section 18152.5,
25 subd. (e)(9). (App. Opening Br., p. 4.) Schedule 100R is used by taxpayers who are required to
26 apportion business income. This schedule includes a section in which a business reports its total payroll,
27 its payroll within California, and the resulting percentage of the business’s payroll within California.
28 Appellant asserts that, for purposes of Schedule 100R, R&TC section 25120, subd. (c), provides that

1 compensation means wages, salaries, commissions, and any other form of remuneration paid to
2 employees for personal services. (See also Cal. Code Regs., tit. 18, § 25132, subd. (a)(3).) (*Ibid.*)
3 Appellant, however, asserts that R&TC section 18152.5 does not use and, is not equivalent to, the
4 concept of compensation paid for purposes of determining total payroll expense and that the statute does
5 not refer to Schedule 100R or the payroll apportionment formula. (*Ibid.*)

6 Appellant asserts that CrossWorlds made use of various stock option plans (statutory
7 stock options (also known as incentive stock options) and nonstatutory stock options) as part of its
8 compensation packages to employees between 1997 and 2000. As such, appellant contends that the
9 corporation's payroll expense should not only include the various stock options granted and vested to
10 employees but also payroll taxes, administrative costs, and various other miscellaneous employee
11 benefits. Appellant asserts that her interpretation of "total payroll expense" is reasonable in light of the
12 term's use and the interpretation is consistent with generally accepted accounting principles and with the
13 actual language of the statute. (App. Opening Br., pp. 6-7; App. Reply Br., p. 5.)

14 Appellant asserts that respondent determined CrossWorld's payroll to be, based upon the
15 corporation's Schedule 100R, the following (App. Opening Br., p. 5):

Tax Year	California	All Locations (including California)	California Percentage
1996	---	---	100%
1997	\$5,527,353	\$6,552,785	84.35%
1998	\$13,036,552	\$17,933,986	72.69%
1999	\$15,499,822	\$21,788,678	71.14%
2000	\$22,403,349	\$34,493,339	64.95%
2001	\$26,014,287	\$45,102,369	57.68%

22 Appellant, however, asserts that CrossWorlds's total payroll expense is not reflected on Schedule 100R,
23 as the Schedule 100R fails to reflect additional compensation earned by employees via stock options
24 between 1997 and 2000. When including these amounts, appellant states that CrossWorlds's total
25 payroll expense is as follows (App. Opening Br., p. 6):

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	(A)	(B)	(C)	(D) (A + C)	(E) (B + C)	(F) (D ÷ E)
Tax Year	California Payroll	Payroll for All Locations	Additional Compensation	Total Calif. Payroll Expense	Total Payroll Expense All Locations	Calif. %
1996	---	---	---	---	---	100%
1997	\$5,527,353	\$6,552,785	\$2,796,796	\$8,324,149	\$9,349,581	89.03%
1998	\$13,036,552	\$17,933,986	\$28,634,058	\$41,670,610	\$46,568,044	89.48%
1999	\$15,499,822	\$21,788,678	\$39,603,576	\$55,103,398	\$61,392,254	89.76%
2000	\$22,403,349	\$34,493,339	\$85,746,796	\$108,150,145	\$120,240,135	89.95%
2001	\$26,014,287	\$45,102,369	---	\$26,014,287	\$45,102,369	57.68%

Appellant asserts that, for the stock acquired on March 11, 1996, the corporation met the active business requirements of R&TC section 18152.5 for 85.07 percent of appellant's holding period (i.e., for 57 of the 69 months that appellant held the stock). (App. Opening Br., p. 10.) Likewise, appellant asserts that, for the stock acquired on November 15, 1996, the corporation met the active business requirements of R&TC section 18152.5 for 80.64 percent of appellant's holding period (i.e., for 50 of the 62 months that appellant held the stock). (App. Opening Br., p. 10.) In addition, appellant asserts that CrossWorlds exceeded the 80 percent payroll test over appellant's 60-month holding period. (App. Opening Br., p. 6.) As a result, appellant contends that, since CrossWorlds used at least 80 percent of its assets and 80 percent of its payroll in the active conduct of a qualified trade or business in California during substantially all of appellant's holding period of the stock, CrossWorlds qualified as a qualified small business and appellant's shares in the corporation qualified as qualified small business stock. (*Ibid.*)

Appellant also criticizes respondent's reliance upon the payroll factor provided by Schedule 100R as a basis for determining total payroll expense, as the payroll factor only references taxable compensation paid to employees. Appellant asserts that the focus in determining total payroll expense should not be on employees' taxable income or whether the corporation receives a deduction for tax purposes. Instead, appellant argues that it was appropriate to add stock options into the payroll factor amounts on Schedule 100R to convert the compensation-based payroll factor into a payroll expense factor. Appellant asserts that she added in stock options awarded to employees, which were treated as a payroll expense by CrossWorlds, to the payroll factor to calculate the payroll expense. (App. Reply Br., pp. 4-5.)

1 Appellant argues that her method of calculating CrossWorlds’s payroll expense is
2 reasonable as it is based upon the corporation’s SEC filings. Appellant states that the “weighted average
3 price” is the pricing methodology used by the SEC for the reporting of stock options and, as such, is a
4 reasonable method for determining CrossWorlds’s payroll expense. Finally, appellant asserts that even
5 if only \$2,500,000 of stock options were paid in 2000, as alleged by respondent, the 80 percent payroll
6 test would still have been met for substantially all of appellant’s holding period of the stock. (App.
7 Reply Br., pp. 5-6.)

8 Defining the Term “Substantially All”

9 Appellant asserts that the term “substantially all,” for purposes of determining whether a
10 corporation has met the active business requirements of R&TC section 18152.5 is 80 percent, citing
11 various Internal Revenue Code (IRC) and R&TC statutes. (App. Opening Br., p. 8.) For example,
12 regarding federal statutes, appellant cites IRC section 302 (regarding distributions in redemption of
13 stock) which describes the term “substantially disproportionate” as less than 80 percent and IRC section
14 368 (Treas. Reg. Section 1.368-2(d)(2)) (regarding corporate distributions) which defines the term
15 “substantially all” as at least 80 percent. Regarding California law, appellant cites R&TC sections 6006,
16 23251, and 24451 among other statutes and regulations for the proposition that “substantially all” is
17 defined as 80 percent.⁵

18 In addition, appellant also notes that the Board concluded in the *Appeal of Helen Cantor*,
19 *et. al.*, 2002-SBE-008, Nov. 3, 2002, that the term “substantially equivalent,” in the context of a
20 homeowners and renters property tax assistance appeal, could be reasonable defined as at least 80
21 percent. Appellant contends that the Board in *Cantor* was only defining the term “substantially,” such
22 that the Board’s conclusion is applicable to cases when either the terms “substantially equivalent” or
23 “substantially all” are at issue. (App. Reply Br., p. 6.)

24 Appellant also contends that the use of the term “substantially all” under federal tax law
25 supports her conclusion. Appellant notes that, of the 18 examples which respondent summarized of the
26 term’s use in Treasury Regulations (Resp. Opening Br., Appendix B), nearly two-thirds of the examples
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28 ⁵ Appeals Division staff (staff) was unable to find any definition of the term “substantially all” in R&TC sections 6006,
23251, or 24451.

1 define the term as 80 percent or less and one-third of the examples define the term as 85 percent or
2 more.⁶ (App. Reply Br., p. 7.)

3 *The Requisite Holding Period*

4 Appellant contends that R&TC section 18152.5 only requires a five-year holding period
5 for qualification for the exclusion of the gain, such that a corporation must only meet the active business
6 requirements of R&TC section 18152.5, subd. (e), during substantially all of a taxpayer's first five years
7 of holding the stock. Here, appellant states that, under this criteria, the stock acquired on March 11,
8 1996, met the active business requirements of the statute for 95 percent (i.e., 57 of 60 months) of that
9 particular five-year holding period. Appellant also states that, under this criteria, the stock acquired on
10 November 15, 1996, met the active business requirements of the statute for 83.33 percent (i.e., 50 of 60
11 months) of that particular five-year holding period.⁷ (App. Opening Br., p. 10-11.) Appellant contends
12 that once a taxpayer satisfies the five-year holding period requirement, and the active business
13 requirements for that five-year period are met, the taxpayer cannot be disqualified under section 18152.5
14 by continuing to hold the stock beyond that period of time. (App. Reply Br., p. 3.)

15 Appellant also argues that a five-year holding period requirement appears three times in
16 the statute, such that the "holding period" under subdivision (c)(2)(A) of R&TC section 18152.5 should
17 also be considered to be five years. First, appellant notes that subdivision (b)(2) of the statute states that
18 "[f]or purposes of this subdivision, the term 'eligible gain' means any gain from the sale or exchange of
19 qualified small business stock held for more than five years." Next, appellant notes that subdivision
20 (g)(2)(A) of the statute provides that an interest held in a pass-through entity qualifies for exclusion
21 under subdivision (a) if, among other requirements, the stock "was held by [the pass-through] entity for
22 more than five years." Finally, appellant notes that subdivision (h)(2)(C) of the statute discusses the
23 transfer of stock by a partnership which must meet certain requirements "without regard to the five-year
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25 ⁶ Staff reviewed Appendix B of Respondent's Opening Brief, which is entitled "'SUBSTANTIALLY ALL' IN INTERNAL
26 REVENUE CODE REGULATIONS." There are 18 examples listed in Appendix B; 13 of the 18 examples define the term
27 "substantially all" as 85 percent or more.

28 ⁷ In her reply brief, appellant asserts that CrossWorlds employed more than 80 percent of its payroll in California for 100
percent of the 60-month period in the five-year qualifying period under the statute. In addition, appellant asserts that
CrossWorlds employed more than 80 percent of its payroll in California for 85.7 percent of the entire period in which
appellant held CrossWorlds's stock. (App. Reply Br., p. 6.)

1 holding period requirement.” Appellant contends that respondent inappropriately dismisses these
2 statutory provisions as merely being a threshold requirement for qualification for the exclusion. (App.
3 Reply Br., p. 7.)

4 Constitutionality of the Statute

5 Appellant asserts that the requirements of the 80 percent asset test and the 80 percent
6 payroll test imposed by California law on small business stock violates the Commerce Clause of the
7 United States Constitution, as courts have found that in-state tax incentives are unconstitutional.
8 Appellant contends that R&TC section 18152.5 discriminates against interstate commerce on its face by
9 providing differential tax treatment which benefits in-state economic interests while burdening out-of-
10 state economic interests. (App. Opening Br., p. 13-14.)

11 Respondent’s Contentions

12 The 80-Percent Payroll Test

13 Respondent asserts that CrossWorlds met the 80 percent payroll test during only 31
14 percent of appellant’s holding period (i.e., 22 out of 71 months) and that this percentage was not
15 substantially all of appellant’s holding period (Resp. Opening Br., p. 5):⁸

	Calif. Payroll %	Total Holding Period	Corp. Met the Requirement	Corp. Does Not Meet the Requirement
1996	100%	10	10	0
1997	84.35%	12	12	0
1998	72.69%	12	0	12
1999	71.14%	12	0	12
2000	64.95%	12	0	12
2001	57.68%	12	0	12
2002	0.18%	1	0	1
Total	---	71	22	49

23 Consequently, respondent concluded that CrossWorlds’s stock could not be considered qualified small
24 business stock and that appellant was not entitled to exclude 50 percent of the gain from the sale of the
25 stock. (Resp. Opening Br., p. 5.)

26 As for the definition of “payroll expense,” respondent agrees that compensation in the
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28 ⁸ Staff notes that respondent’s calculation relates to the CrossWorlds’s stock which appellant acquired in March 1996.

1 form of stock options should be considered, and included, for purposes of determining CrossWorlds's
2 payroll expense. Respondent acknowledges that there are two types of stock options: statutory stock
3 options (also known as incentive stock options) and nonstatutory stock options. Respondent asserts that
4 statutory stock options do not result in a taxable event to an employee and employers are not allowed a
5 deduction related to the issuance of such options. However, respondent asserts that an employee
6 recognizes income at either the grant or the exercise date of a nonstatutory stock option and an employer
7 is allowed a corresponding deduction related to that income recognition. Consequently, respondent
8 argues that a corporation's payroll expense should only reflect the issuance of nonstatutory stock
9 options. Here, however, respondent contends that appellant has failed to provide any evidence that
10 CrossWorlds actually issued nonstatutory stock options. (Resp. Opening Br., pp. 7-8.)

11 In addition, respondent contends that appellant has not explained how the payroll factor
12 reported on Schedule 100R doesn't already reflect payroll expenses which include stock options.
13 Respondent further contends that, even if the payroll factor reported on Schedule 100R failed to reflect
14 some of the stock options issued by CrossWorlds as compensation, appellant's method of determining
15 the amount of compensation or payroll expense associated with the stock options and the sourcing of
16 that compensation is unreasonable. Respondent asserts that appellant allocated all of the compensation
17 expense associated with stock options entirely to California despite the fact that CrossWorlds had
18 employees in eleven states and three foreign countries. (Resp. Opening Br., p. 8.)

19 Respondent also contends that appellant's method of determining compensation
20 associated with stock options is unreasonable. Respondent asserts that CrossWorlds stated on its
21 December 31, 2000 Form 10-K, filed with the SEC, that deferred-based compensation expense is
22 recorded if, on the grant date, the fair market value of the stock option exceeds the exercise price, and
23 that its deferred stock-based compensation for fiscal year 2000 was \$2,500,000. (Resp. Opening Br.,
24 Exhibit E, p. 6-7.) Respondent argues that this amount is in contrast to the \$85,746,796 in compensation
25 expense associated with stock options for 2000 which appellant alleges was 100 percent attributable to
26 California.

27 Respondent further argues that appellant's method of calculating compensation expense
28 attributable to stock options for 2000 takes the cumulative number of options which were granted by

1 CrossWorlds between 1997 and 2000 and multiplies this total by the “weighted average exercise price.”
2 Respondent asserts that appellant offers no explanation as to: (1) why this method is reasonable; (2) why
3 it was appropriate to use all of the stock options granted in previous years to determine the year 2000’s
4 stock option amount; (3) why a different methodology was used for 1997, 1998, and 1999; or (4) the
5 reasoning for the use of, and the underlying assumptions of, the “weighted average price,” which is a
6 pricing model used under the “fair value” method (as discussed below). (Resp. Opening Br., p. 9; Resp.
7 Reply Br., p. 9.) Respondent also claims that there are discrepancies in appellant’s calculations of the
8 number of stock options granted for 1997, 1998, and 1999.⁹ (Resp. Reply Brief, p. 9, fn. 5.)

9 Respondent asserts that, in 1995, the Financial Accounting Standards Board (FASB)
10 revised the reporting standard (via Statement of Financial Accounting Standards No. 123, *Accounting*
11 *for Stock-Based Compensation* (FAS123)) for the reporting of compensation related to stock options
12 from an “intrinsic value” methodology to a “fair value” methodology. However, respondent explains
13 that FAS123 allowed a company to continue to use the “intrinsic value” method but required the
14 disclosure of certain financial data as if the “fair value” method had been applied. (Resp. Reply Br.,
15 p. 8; Exhibit L, p. 3.)

16 Respondent asserts that, under the “intrinsic value” method, the reported compensation
17 expense is limited, as compensation expense is measured at the time the stock option is granted,
18 measured by the difference between the market price and exercise price at the grant date. In contrast,
19 respondent asserts that, under the “fair value” method, compensation expense is measured at the time the
20 option is granted using an option pricing model. As a result, respondent contends that the “fair value”
21 method accounts for increases in the value of the stock over time, resulting in a much larger amount of
22 compensation expense when using this methodology. (Resp. Reply Br., p. 8.) In support of this,
23 respondent quotes from CrossWorlds’s December 31, 2000 Form 10-K which states that

24 The Company uses the intrinsic value method to account for its fixed option plans issued
25 to employees. . . . Had compensation cost for the Company’s stock-based compensation
26 plan been determined consistent with SFAS No. 123 for all of the Company’s stock-

27 ⁹ Respondent asserts that appellant states that the number of shares represented by options granted in 1997 was 1,381,005.
28 However, respondent asserts that this total reflects the number of options granted in 1998. In addition, respondent asserts that
this same discrepancy occurred in 1998 and 1999. Finally, respondent asserts that appellant failed to subtract the number of
shares cancelled from the number of shares granted.

1 based compensation plans, net loss and basic and diluted net loss per share would have
2 been as follows: . . .

3 The fair value of each option was estimated on the date of grant using a Black-Scholes
4 option pricing model with the following weighted-average assumptions: . . .

(Resp. Opening Brief, Exhibit E, pp. 9-10.)

5 Respondent reiterated that for tax year 2000 CrossWorlds used the “intrinsic value”
6 method to determine stock option-related compensation expense of only \$2,500,000. Respondent
7 asserts that appellant’s calculation of CrossWorlds’s stock option-related compensation is merely
8 appellant’s unique calculation of utilizing selected data of CrossWorlds’s “fair value” disclosure
9 information. (Resp. Reply Br., pp. 8-9.)

10 In summary, respondent argues that appellant’s methodology of determining the value of
11 CrossWorlds’s stock options as compensation overstates CrossWorlds’s payroll expense attributable to
12 California. In addition, respondent argues that even if the \$2,500,000 stock option-related compensation
13 expense wasn’t previously included in the Form 100R payroll factor, and this amount was entirely
14 attributable to CrossWorlds’s California employees, CrossWorlds would have still failed to meet the 80
15 percent payroll test for 2000 (Resp. Opening Br., pp. 9-10):

16 Calif. Payroll on Sch. 100R	17 Payroll All Locations	18 Calif. %	19 Stock Option Compensation	20 Revised Calif. Payroll	21 Revised Calif. %
22 \$22,403,349	23 \$34,493,339	24 65%	25 \$2,500,000	26 \$24,903,349	27 72%

18
19 *Defining the Term “Substantially All”*

20 Regarding the term “substantially all,” respondent asserts that this term should be defined
21 as 85 percent. Respondent argues that a federal empowerment zone statute, passed as part of the federal
22 Revenue Reconciliation of 1993, at the same time as the federal small business stock statutes were
23 enacted, defines the term “substantially all” as 85 percent. Respondent argues that the statutes govern
24 the same subject matter, were enacted at the same time, and there is a presumption that Congress meant
25 for the statutes to be read consistently. (Resp. Opening Br., pp. 10-11.) In addition, respondent
26 reviewed various Treasury Regulations and found the term “substantially all” defined as 85 percent or
27 more 13 out of 18 times. (Resp. Opening Br., Appendix B; Resp. Reply Br., p. 10.)

28 Respondent also points out that if “substantially all” is defined as less than 85 percent, a

1 corporation could have no payroll or assets in California for an entire year, out of a 5-year period, and
2 still meet the active business requirements of R&TC section 18152.5. (Resp. Opening Br., p. 11.)
3 Finally, respondent asserts that appellant’s reliance on the Board’s decision in the *Appeal of Helen*
4 *Cantor, et. al., supra*, is inappropriate because (1) the term being defined was “substantially equivalent”
5 not “substantially all,” such that the Board’s opinion did not address qualified small business stock; and
6 (2) the term “substantially all” is a technical term which has been used repeatedly in both federal and
7 California tax statutes. (Resp. Opening Br., p. 12.)

8 *The Requisite Holding Period*

9 Respondent disagrees with appellant’s assertion that the active business requirements of
10 R&TC section 18152.5 must only be met during the initial 5-year (60-month) period after a taxpayer’s
11 acquisition of qualified small business stock. Respondent argues that the 5-year holding period of
12 R&TC section 18152.5, subd. (a), is the minimum threshold which must be met in order for a taxpayer
13 to be eligible to exclude gain from the sale of qualified small business stock. However, respondent
14 asserts that stock must meet the active business requirements of subdivision (e) of R&TC section
15 18152.5 during a taxpayer’s entire holding period to be considered qualified small business stock.
16 (Resp. Opening Br., pp. 12-13; Resp. Reply Br., pp. 2-4.) In other words, respondent asserts that the
17 5-year holding period is a minimum threshold which must be met before a taxpayer is eligible to exclude
18 gain. (Resp. Reply Br., p. 4.)

19 *Constitutionality of the Statute*

20 Respondent argues that it is required to enforce R&TC section 18152.5 as mandated by
21 Article III, section 3.5, of the California Constitution in that no administrative agency has the power to
22 refuse to enforce a statute on the basis that it is unconstitutional unless an appellate court has determined
23 it to be unconstitutional. (Cal. Const., art. III, § 3.5, subd. (a).) Consistent with this, respondent asserts
24 that the Board has a policy of abstaining from deciding constitutional issues.

25 In addition, respondent argues that, as to whether the statute is in violation of the
26 Commerce Clause of the United States Constitution, R&TC section 18152.5 applies equally to foreign
27 and domestic corporations. Respondent contends that corporations can engage in unlimited interstate
28 business such that a corporation’s entire gross receipts or sales can be outside of California and its

1 investors could still be eligible for the small business stock exclusion. In addition, respondent asserts
2 that both intrastate and interstate commerce are equally impacted to the extent that a corporation has
3 only 79 percent or less of its assets or payroll in California for the relevant period of time.

4 Applicable Law

5 It is well settled that a presumption of correctness attends respondent's determinations as
6 to issues of fact and that an appellant has the burden of proving such determinations erroneous. (*Appeal*
7 *of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Jun. 29, 1980.) This presumption is, however, a
8 rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary.
9 (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) Respondent's determination cannot, however, be
10 successfully rebutted when the taxpayer fails to present uncontradicted, credible, competent, and
11 relevant evidence to the contrary. (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) To overcome the
12 presumed correctness of respondent's findings as to issues of fact, a taxpayer must introduce credible
13 evidence to support his assertions. When the taxpayer fails to support his assertions with such evidence,
14 respondent's determinations must be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) A
15 taxpayer's unsupported assertions are not sufficient to satisfy his burden of proof. (*Appeal of James C.*
16 *and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

17 R&TC section 18152.5 provides that, under certain circumstances, a taxpayer may
18 exclude 50 percent of the gain from the sale of qualified small business stock. (Rev. & Tax. Code,
19 § 18152.5, subd. (a).) Although IRC section 1202 also provides for a 50 percent exclusion of the gain
20 from the sale of qualified small business stock, the Legislature specifically provided that this statute is
21 not applicable to determining California income.¹⁰ (Rev. & Tax. Code, § 18152, subd. (a).)

22 Qualification for the exclusion from gain under R&TC section § 18152.5 includes
23 meeting a variety of requirements. Pertinent here are various requirements under subdivisions (a), (c),
24 (d), and (e) of the statute. First, subdivision (a) of the statute mandates that, to qualify for the exclusion
25 of gain, stock must be "held for *more than* five years" by a shareholder. Second, the term "qualified
26

27 ¹⁰ Subdivision (l) of R&TC section 18152.5 also provides that:

28 "It is the intent of the Legislature that, in construing this section, any regulations that may be promulgated by the Secretary of Treasury under Section 1202(k) of the Internal Revenue Code shall apply to the extent that those regulations do not conflict with this section or with any regulations that may be promulgated by the Franchise Tax Board."

1 small business stock” is considered any stock in a C corporation which is originally issued after April
2 10, 1993 if (1) as of the date of issuance, the corporation is a qualified small business, and (2) the stock
3 is acquired by the taxpayer at the time of its original issuance in exchange for money, property (not
4 including stock), or as compensation for services. (Rev. & Tax. Code, § 18152.5, subd. (c)(1).) A
5 corporation is a “qualified small business” if “[a]t least 80 percent of the corporation’s payroll, as
6 measured by total dollar value, is attributable to employment located in California.” (Rev. & Tax. Code,
7 § 18152.5, subd. (d)(1)(C).)

8 To further define the term “qualified small business stock,” subdivision (c) of R&TC
9 section 18152.5 provides that stock in a corporation will not be treated as qualified small business stock
10 unless, during substantially all of a taxpayer’s holding period of the stock, the corporation meets the
11 active business requirements delineated in subdivision (e) of the statute. (Rev. & Tax. Code, § 18152.5,
12 subd. (c)(2)(A).) Under subdivision (e), at least 80 percent (by value) of a corporation’s assets must be
13 used in the active conduct of qualified businesses in California. (Rev. & Tax. Code, § 18152.5, subd.
14 (e)(1)(A).) In addition, no more than 20 percent of a corporation’s total payroll expense can be
15 attributable to employment located outside of California. (Rev. & Tax. Code, § 18152.5, subd. (e)(9).)
16 Or, in other words, 80 percent or more of a corporation’s total payroll expense must be attributable to
17 employment in California. As such, a corporation meets the active business requirements of R&TC
18 section 18152.5, subd. (e), if, during substantially all of a taxpayer’s holding period of the stock, the
19 corporation meets the 80 percent asset test (Rev. & Tax. Code, § 18152.5, subd. (e)(1)(A)) and the 80
20 percent payroll test (Rev. & Tax. Code, § 18152.5, subd. (e)(9)).

21 The parties dispute whether stock options can be included as part of CrossWorlds’s
22 payroll expense and the definition of the term “substantially all.” Regarding the issue of statutory
23 construction, in order to determine the Legislature’s intent so as “to effectuate the purpose of the law,”
24 one must “first look to the words of the statute themselves, giving to the language its usual, ordinary
25 import and according significance, if possible, to every word, phrase and sentence A construction
26 making some words surplusage is to be avoided.” In addition, statutory language “must be construed in
27 context, keeping in mind the statutory purpose, and statutes or statutory sections relating to the same
28 subject must be harmonized, both internally and with each other, to the extent possible. Where

1 uncertainty exists consideration should be given to the consequences that will flow from a particular
2 interpretation.” (*Dyna-Med, Inc. v. Fair Employment & Housing Com.* (1987) 43 Cal.3d 1379, 1386-87,
3 citations omitted.)

4 Regarding the issue of constitutionality, the United States Constitution gives Congress
5 the power to regulate commerce between the states. (U.S. Const., art. I, § 8, cl. 3.) However, the
6 California Constitution prohibits, in pertinent part, an administrative agency from refusing to enforce a
7 statute unless an appellate court has determined that the statute is unconstitutional. (Cal. Const., art. III,
8 § 3.5.) Furthermore, this Board has a well-established policy of abstaining from deciding constitutional
9 issues. (Cal. Code Regs., tit. 18, § 5412, subd. (b); *Appeal of Aimor Corp.*, 83-SBE-221, Oct. 26, 1983;
10 *Appeal of Vortex Manufacturing Co.*, 30-SBE-017, Aug. 4, 1930.) This policy is based upon the
11 absence of any specific statutory authority which would allow respondent to obtain judicial review in
12 such cases and upon our belief that judicial review should be available for questions of constitutional
13 importance. (*See Appeal of Aimor Corp., supra; Appeal of Vortex Manufacturing Co., supra.*)

14 STAFF COMMENTS

15 As discussed above, subdivision (c)(2)(A) of R&TC section 18152.5 provides that
16 “[s]tock in a corporation shall not be treated as qualified small business stock unless, during
17 *substantially all* of the taxpayer’s *holding period* for the stock, the corporation meets the *active business*
18 *requirements* of subdivision (e) . . .” (Italics added.) One of the active business requirements of
19 subdivision (e) of R&TC section 18152.5 is the 80 percent payroll test, in which 80 percent or more of a
20 corporation’s *total payroll expense* must be attributable to employment in California.

21 Here, three sub-issues relating to qualification under R&TC section 18152.5 are of
22 concern: (1) what amount of the stock options granted by CrossWorlds can be included as part of the
23 corporation’s “total payroll expense”; (2) the definition of the term “substantially all” as part of the
24 clause “substantially all of the taxpayer’s holding period of the stock”; and (3) the definition of the term
25 “holding period” as part of the clause “the taxpayer’s holding period of the stock.”

26 Appellant argues that the term “substantially all” means 80 percent or more and that the
27 term “holding period” means the first five years that a taxpayer holds stock in a qualified small business.
28 Together, appellant argues that CrossWorlds met the 80 percent payroll test requirement as, for 80

1 percent or more of appellant’s first five years of holding CrossWorlds’s stock, 80 percent of
2 CrossWorlds’s payroll was attributable to California. (See the table on page 6 of the brief.)

3 Respondent argues that the term “substantially all” means 85 percent or more and that the
4 term “holding period” means the entire length of time that a taxpayer holds stock in a qualified small
5 business. Together, respondent argues that CrossWorlds failed to meet the 80 percent payroll test
6 requirement as CrossWorlds met this test during only 31 percent of appellant’s entire holding period of
7 CrossWorlds’s stock. (See the tables on page 5 and page 9 of the brief.)

8 Regarding the 80 percent payroll test, this issue also concerns what types of expenses
9 should be included in determining “total payroll expense” in meeting the requirement of subdivision
10 (e)(9) of R&TC section 18152.5. In this appeal, the specific issue is whether compensation expenses
11 related to stock options should be included in the calculation of “total payroll expense.” Respondent
12 acknowledges that CrossWorlds’s payroll expense should include stock option-related compensation.
13 At issue in determining whether CrossWorlds met the 80 percent payroll test is (1) how much stock
14 option-related compensation has already been reflected on the Schedule 100R’s filed by CrossWorlds
15 (2) what additional amount of stock option-related compensation, if any, should be included in the
16 calculation of CrossWorlds’s payroll expense during appellant’s holding period of the stock, and (3)
17 how such stock options should be calculated.

18 Appellant should be prepared to explain: (1) why the Schedule 100R’s filed by
19 CrossWorlds do not already reflect all of the stock option-related compensation expense of
20 CrossWorlds; and (2) why it was appropriate to attribute 100 percent of the stock option-related
21 compensation expense to CrossWorlds’s California payroll. In addition, appellant should also be
22 prepared to explain how the additional stock option-related compensation expense which she includes as
23 part of CrossWorld’s California payroll was calculated, including: (1) why the use of the “weighted
24 average exercise price” as a value for stock options was reasonable; (2) if, and how, appellant was
25 consistent in her calculation of stock option-related compensation for each of the years; and (3) whether
26 appellant valued the correct number of stock options each year, as explained in the next paragraph. If
27 there are any errors in appellant’s computations, such errors would affect the amount of stock option-
28 related compensation which appellant asserts should be included CrossWorlds’s California payroll for

1 the years at issue and whether CrossWorlds meets the 80 percent payroll test.

2 Staff compared the summary of CrossWorlds's stock options on the corporation's
3 December 31, 2000 Form 10-K (Resp. Opening Br., Exhibit E, p. 10) with appellant's calculation of
4 additional compensation attributable to stock options on page 6 of her opening brief. It appears that the
5 "net options granted" as calculated by appellant in her opening brief for the years 1997, 1998, and 1999,
6 should instead be attributable to the years 1998, 1999, and 2000, respectively. Consequently, it appears
7 that the additional compensation attributable to stock options for these years as calculated by appellant
8 (\$2,796,796 for 1997; \$28,634,058 for 1998; and \$39,603,576 for 1999 (App. Opening Br., p. 6)) should
9 instead be attributable to 1998, 1999, and 2000, respectively. According to the Form 10-K, 10,993,179
10 shares were available as stock options as of December 31, 2000. During calendar year 2000,
11 CrossWorlds's net stock options granted totaled only 4,199,743 shares. However, appellant calculated
12 additional compensation for 2000 based upon 10,993,179 shares. (Resp. Opening Br., Exhibit E, p. 10.)

13 Regarding the issue of constitutionality, the Board is an administrative agency. As such,
14 it is precluded from refusing to enforce a statute on the basis that the statute is unconstitutional, unless
15 and until an appellate court holds that particular statute to be unconstitutional (Cal. Const., Art. III,
16 § 3.5). Here, no appellate court has held that R&TC section 18152.5 is unconstitutional. Staff notes that
17 the constitutionality of the statute's active business requirement is currently before the Los Angeles
18 County Superior Court in a case set for trial in July 2011.¹¹

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¹¹ This is a reference to the pending matter, *Cutler v. Franchise Tax Board* (Super. Ct. Los Angeles County, No. BC421864).